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March 31, 2003

TO: Each Supervisor

FROM: Thomas L. Garthwaite, MD
Director and Chief Medical Officer

SUBJECT: **STATUS OF DISCUSSIONS WITH INTERESTED PARTIES OVER
THE FUTURE OF RANCHO LOS AMIGOS**

On January 28, 2003, your Board approved the Department's recommendation to close Rancho Los Amigos National Rehabilitation Center (Rancho) and instructed the Director of Health Services' and the Chief Administrative Officer to work with the California Community Foundation (CCF), other non-profit foundations and any interested parties to determine if Rancho can transition to a free standing facility and report back in 60 to 70 days. Your Board further instructed that the report back include information related to the ability to generate the revenues necessary to offset the net County costs associated with operating during the transition period between now and any takeover.

This is to provide your Board with an update on these activities.

BACKGROUND

Following the January 28 hearing, the Department and CAO formed a Governance Conversion Working Group comprised of representatives from the Chief Administrative Office, County Counsel, the DHS Chief Operating Officer, Rancho clinical leadership, LAC+USC clinical leadership and Harbor-UCLA clinical

leadership. A representative of SEIU Local 660 was subsequently included in the Working Group. The Working Group has been charged with providing information and technical expertise to CCF and other interested parties and identifying the issues surrounding transitioning Rancho to a private, non-profit and the development of work plans and time-lines, costs and other pertinent information to assess the reasonableness of Rancho's viability as a private, non-profit.

It is important to note that the Department originally targeted May 1, 2003 for the first round of employee reductions that will trigger the "employee cascade" process. Because of the 60 to 70 day window to assess the feasibility of Rancho transitioning to a private, non-profit entity, that date was rescheduled to June 30, 2003. The impact of this new date resulted in not achieving approximately \$7.5 million in savings included in the Department's forecast.

CALIFORNIA COMMUNITY FOUNDATION UPDATE

Attached is an update from CCF regarding their efforts to transition Rancho. CCF has retained the services of Gill/Balsano Consulting and engaged Manatt, Phelps & Phillip, LLP to assist them in preparing an analysis of the options to transition Rancho. CCF has been unable to complete a formal feasibility study at this time but they anticipated it to be completed by April 15. They do not expect the major findings to be different than what is included in the attached memorandum. The Department has reviewed the CCF memorandum and the following is a discussion of the major findings in that document.

Approach and Timing Issues

One of the most notable preliminary findings is that "the immediate transition of Rancho to a start-up non-profit entity is not feasible. On the other hand, the assumption of Rancho's operations by an existing non-profit hospital or hospital system would result in significant time and cost-savings, facilitating a speedier transition from public to non-profit status."

While CCF has had informal discussions with several hospitals, there has been no formal solicitation to existing hospitals or hospital systems to assess their interest in taking over the operations of Rancho. This approach appears appropriate, however, we cannot evaluate the likelihood of an existing hospital or health system pursuing this option.

Another key assumption that warrants close examination is that “operations as a nonprofit hospital would begin on or about July 1, 2004.” This timeframe appears optimistic given that CCF indicates a one-year transition of ownership would be needed and there is no identified existing hospital or hospital system to take over operation of Rancho at this time.

Timing is a key issue in that if the closure of Rancho is delayed beyond June 30, 2003, the County will incur \$18 million in additional net county costs in FY 2003-04 above the \$14.7 million assumed in the DHS budget.

Costs and Revenue Projections

The approach of CCF’s consultant Gill/Balsano (GBC) to estimate staffing and costs relative to planned clinical program, size and volume of services appears reasonable. It is based on the consultant’s use of accepted industry staffing patterns, pending State regulations on nurse to patient ratios and pay scales adjusted to the Southern California marketplace.

The revenue projections are based on a payer mix that includes 25% indigent over five years. It assumes an increase over the five years in commercial payers to 35% of its overall mix and a decline in Medi-Cal patients to about 30% of its overall mix. The Department is unable to evaluate the assumptions relative to payer mix changes other than to compare them to Rancho’s current payer mix.

The preliminary report assumes that “the new operator would neither undertake or assume any bonded indebtedness relating to Rancho.” The current debt service covering the capital costs of the Jacqueline Perry Institute (JPI building), parking structure and central plant is estimated to be approximately \$15 million annually until Fiscal Year 2006-07 when the bond debt drops to an annual payment of approximately \$7.3 million.

Philanthropy and Transition Costs

As noted earlier, your Board instructed the Department to report back on the ability to generate revenues to off-set the costs of transition. The Department estimates that a scaled down Rancho with a program suitable for transition to a non-profit model will cost \$18 to \$20 million in net county cost to operate.

CCF reports that, in addition to a pledge of \$3 million from the LA Care Health Plan toward the operations of an independent Rancho, that they have secured an additional \$15 million in preliminary commitments over a five-year period. CCF

reports that the availability of additional philanthropic funding is dependent on the development of a viable business plan for an independent Rancho.

Therefore, at this time, there is not a revenue source to offset the net county cost associated with operating Rancho during a transition.

CONCLUSION

We believe that the final Gill Balsano report will conclude that Rancho can operate at a cost consistent with similar facilities nationwide. To date their report does not provide the detail of revenues available to offset those costs. I believe that they will find a business model that has the potential of long-term stability if they can then attract philanthropic support. If the business model is good, CCF believes that there is interest from the philanthropic community. None of these variables can be predicted with certainty.

The cost of additional time for the non-profit model to develop is at a minimum: 1) \$18 million in operational costs annually which represents a reduction in net county cost of about \$40 million from the current program, 2) the turmoil of downsizing this year with a potential for closure next year, and 3) the opportunity cost of the facility or its bond debt. CCF's current model requires the interest and participation of a not-for-profit system.

On the plus side, using an existing private not-for-profit health adds resources, management skill, and would speed a transition. On the negative side, not-for-profit systems are currently facing considerable pressure and uncertainty in terms of imminent cuts in Medi-Cal due to the state budget crisis, increasing pressures from the uninsured due to the poor economy, poor return on investments due to the down turn in the stock market, and pressures for both Medicaid and Medicare reform nationally.

At your direction, we have been proceeding along parallel tracts to close or create a bridge model to a non-profit. Because of the imminent action to curtail admissions and run the employee cascade, we will proceed to close unless otherwise instructed.

Please let me know if you have any further questions.

TLG:il
Attachment

c: Chief Administrative Officer
County Counsel
Executive Officer, Board of Supervisors



CALIFORNIA COMMUNITY
FOUNDATION

*cc: Leaf, Kamsant
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Memorandum

Date: March 25, 2003

To: Thomas L. Garthwaite, M.D.,
Director and Chief Medical Officer
County of Los Angeles
Department of Health Services

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From: Jack Shakely, President

Re: Update on Rancho Los Amigos Activities

Introduction

This memorandum is intended to update the Department of Health Services ("DHS") on the activities of the California Community Foundation ("Foundation") relating to Rancho Los Amigos National Rehabilitation Center ("Rancho"). Before outlining our status, allow me to acknowledge the considerable assistance provided by DHS in support of the voluntary efforts we undertook to examine possible pathways to secure the future of Rancho Los Amigos rehabilitation services. Among other things, DHS has been instrumental in providing data that underlies some of our business model analysis, has provided encouragement on our efforts to explore opportunities, and has assisted our preliminary evaluation of possible challenges in transitioning to a new Rancho model.

Over the past few weeks, it has become quite clear to us that any transition of Rancho to a nonprofit facility will be a complex and multi-layered process, involving numerous issues and opportunities. We strongly believe that these efforts are worthwhile, given the important and unique rehabilitation services for which Rancho is widely recognized. We consider it a privilege to assist in attempting to frame a workable solution.

Background

In accord with the Foundation's goal to be a solution broker, our primary aim in this project is to explore and summarize some key parameters of an alternative model that might preserve Rancho's high-quality rehabilitation services. To that end, we have engaged experts and resources that might not otherwise be available to the County—at an estimated cost of about \$600,000 over the four month research period from January through April 2003.

ENDOWING THE FUTURE OF LOS ANGELES COUNTY SINCE 1915

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Foundation engaged the Los Angeles office of Manatt, Phelps & Phillips, LLP, and particularly James Schwartz and Mark Windisch, who are experts in this arena. Mr. Schwartz and Mr. Windisch have addressed a number of topics with GBC, and have made preliminary contacts with several nonprofit organizations that might be interested in operating Rancho. Exploratory meetings have already been set with one or more of these organizations. It is our understanding that DHS is putting together appropriate materials to enable potential successor operators to conduct due diligence relating to a potential transaction. In addition, the Foundation is fully committed to sharing the GBC report with those nonprofit healthcare organizations that show interest in evaluating possibilities relating to Rancho.

It seems clear that this activity will take some time to develop, especially while any interested parties pursue a due diligence process. If these opportunities are to be realized, we believe the time and cost will be worthwhile. Ultimately, we understand and appreciate that the decision regarding timing and the survival of Rancho must and does rest solely with the County.

Physicians

Additional aspects warranting attention, but outside the scope of GBC's work, are the structural operating differences and cash flow problems that might confront physicians at Rancho under a nonprofit model. Currently, most of Rancho's physicians are employed directly by the County, and as such, they receive salaries and benefits. Under a nonprofit hospital model, the physicians probably would need to organize and bill separately in accord with California law. This could result in severe cash flow disruptions for the physicians, due to start-up costs and significant delays in their receipt of payments from third parties. For example, their initial billings could take 90 days or more to be paid. Although we are not involved in this part of the process, we anticipate that the physicians are reviewing and evaluating these topics.

Real Estate

To gain an understanding of the real estate situation, we met with Gerald Caton, the City Manager of Downey. At that meeting, Mr. Caton emphasized that Downey has the power over local zoning, and he would like to see the unused Rancho property developed to create more jobs. He pledged his assistance to achieve this. Although it is beyond our current scope, we note that real estate development opportunities at Rancho potentially could offer benefits to the County, the City of Downey and a nonprofit operator of the hospital.

Philanthropy

Although there clearly are not enough philanthropic dollars to seed creation of a start-up nonprofit hospital, the Foundation has preliminary commitments that could assist in transitioning Rancho to an existing nonprofit operator. We believe that the

- The new operator would lease the facility from the County for \$1/year, including existing equipment.
- The new Rancho would be a 150-bed facility, with an average daily census of 135 (90% occupancy).
- The new operator would neither undertake nor assume any bonded indebtedness relating to Rancho.
- As a nonprofit hospital, and in accord with California law, the physicians would not be employees of the hospital, but would be required to organize separately.
- Rancho would provide about 49,000 inpatient days annually.
- Rancho would provide about 41,000 to 44,000 outpatient visits annually.
- The number of employees at the new Rancho would be about 769 FTE's (both outpatient and inpatient services, clinical and non-clinical employees).
- Annual operating costs (not including depreciation or physicians) would be less than \$70 million (including clinical and non-clinical staff, materials and supplies, and indirect costs, as well as the Rancho Los Amigos Foundation staff).
- Operations as a nonprofit hospital would begin on or about July 1, 2004.

Staffing

As indicated above, the GBC staffing model anticipates a substantially reduced number of employees at a private nonprofit Rancho.

Revenue

We note that the revenue projections under a nonprofit model are complicated by a number of variables. GBC is currently considering several revenue/patient mix scenarios. These include varying proportions of Medi-Cal patients, indigent patients, and privately insured patients. To assist in this multi-layered analysis, the Foundation is in the process of engaging an additional California-based expert to provide projections and guidance regarding certain Medi-Cal funding streams under several scenarios.

Nonprofit Hospital Operators

To assist in various aspects of the overall analysis, and to facilitate connections to one or more potential nonprofit hospital operators for Rancho, the Foundation

After being approached by the Rancho Los Amigos Foundation in November 2002, we engaged Gill/Balsano Consulting ("GBC") to assess the area's need for rehabilitation services, and to highlight potential options for alternative operating models. GBC is an expert in rehabilitation services and works with many of the top rehabilitation hospitals in the country. The initial GBC report showed that the closure of Rancho would lead to a shortage of 300 rehabilitation beds in the Los Angeles area, and projected that a nonprofit hospital model at Rancho might offer a solution to the situation.

After presenting the initial GBC report at the Beilenson Hearing on January 28, 2003, and with encouragement from the Board of Supervisors to continue our efforts, the Foundation engaged GBC to conduct additional research into a nonprofit hospital model (including patient utilization projections, and various revenue and expense projections).

Nonprofit Model

GBC is currently developing a nonprofit operating model with a variety of revenue scenarios. It now seems clear that the required private funds for an immediate conversion would be prohibitive. Furthermore, the amount of time and resources that would be required to develop a new nonprofit organizational infrastructure, and to install the necessary information systems and technology, strongly suggests that the immediate transition of Rancho to a start-up nonprofit entity is not feasible.

On the other hand, the assumption of Rancho's operations by an existing nonprofit hospital or hospital system would result in significant time and costs savings, facilitating a speedier transition from public to nonprofit status. It is our understanding that, in the private sector, it typically takes about one year to transition ownership of a hospital. Given the various topics and issues that have surfaced to date, we believe that duration may make sense at Rancho as well.

Details of the GBC model for a private nonprofit Rancho are still being refined, and we anticipate the report will be completed by April 15. It will likely include projections over a five-year span. In the meantime, we provide below a list of some key assumptions and highlights of the report. In doing so, we note that the model described below is consistent with current operations at comparable rehabilitation hospitals in other locales.

Key Assumptions of GBC Report

Although the GBC report is still in the research and preparation stage, we wanted to share with you some of the key assumptions and highlights as they are currently developing. They are:

- The new operator would be an existing nonprofit hospital or health system.

generous commitment of \$3 million by LA CARE, and another \$15 million in “handshake” commitments we have achieved so far, could be enough to make Rancho attractive to possible successor operators.

Conclusion

We recognize the County is faced with enormous financial challenges. Moreover, we understand the closure or transition of Rancho involves an array of complicating factors, including cascading staff, union contract concerns, various retirement issues, and the ongoing bond debt associated with Rancho. The proposed nonprofit model cannot address all those issues.

Despite the numerous issues, it is our sincere hope that the research and outreach conducted through our support will lead to a solution that carries Rancho forward for current and future generations. Once the GBC report is completed, we will provide it to you and DHS for your review and consideration, as well as to those nonprofit organizations that indicate an interest in Rancho’s future. It is our foremost hope that one or more nonprofit healthcare organizations will then approach the County for serious discussions regarding an organized transition of Rancho to nonprofit status.